



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service  
230 S. Dearborn Street  
Chicago, IL 60604

January 23, 2015

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Form(s):

990 & 990-T

Tax Year(s) Ended:

12/31/XX, 12/31/XX, 12/31/XX

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Local Taxpayer Advocate

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing  
Director, Exempt Organizations Exams

Enclosures:  
Publication 892  
Publication 3498  
Form 6018  
Form 886-A  
Envelope

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	
<b>Explanation of Items</b>		
Name of Taxpayer ORG		Year/Period Ended 12/31/XX 12/31/XX 12/31/XX

## **ISSUE**

Does ORG ("Club") continue to qualify for exemption under Internal Revenue Code § 501(c)(7) given that it receives more than 35% of its gross receipts, including investment income, from sources outside its membership on a recurring basis?

## **FACTS**

ORG is recognized as an organization exempt under Section 501(c)(7) of the Internal Revenue Code. The Club received exemption on May, 25, 20XX. According to its Articles of Incorporation, the primary purpose of the Club is to promote the intellectual, moral, charitable, religious, benevolent, cultural and recreational interests of its members and the community in general by providing a place for meetings, social functions, recreation and cultural activities, or such other facilities which may further interests on the part of the members of this corporation or the community in general.

The organization's source of financial support for its initial year of operation as an exempt entity, the year ended December 31, 20XX, is investment income. The organization's sources of financial support for subsequent years under examination, years ended December 31, 20XX, and December 31, 20XX, are also investment income. The Club does not receive membership dues. According to its Articles of Incorporation, all members in good standing of the Council No. AA of the automatically become members of ORG. and have the right to vote at any general membership meeting.

The Club filed a Form 1120, U.S. Corporation Income Tax Return, prior to receiving exemption. The real estate and personal property of the Club was sold on December 10, 20XX. Beginning January 10, 20XX, members of Council No. AA held meetings periodically to discuss the options available to them regarding the use of the funds generated by the sale. The funds are currently being held as an investment. The buyers of the property have leased it to a third party who operates it as a restaurant and bar. The new owners continue to provide meeting rooms for the groups who were previously serviced by the Club and also provide a storage room for the organization. All activities are conducted by volunteers of the organization. There are no employees of the organization.

The Club reported the following sources and amounts of revenue on Forms 990 for periods ending December 31, 20XX, December 31, 20XX and December 31, 20XX:

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	20XX	20XX	20XX	
Club Activities-Member	\$ -	\$ -	\$ -	
Club Activities-Nonmember	\$ -	\$ -	\$ -	
Membership Dues and Assessments	\$ -	\$ -	\$ -	
Interest on savings and temporary cash investments	\$ -	\$ -	\$ -	
<b>Total Nonmember Income</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>A</b>
<b>Total Nonmember &amp; Investment Income</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>B</b>
<b>Total Income</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>C</b>
<b>Nonmember % - A/C</b>	0,0%	0,0%	0,0%	
<b>Total Nonmember &amp; Investment % - B/C</b>	100.0%	100.0%	100.0%	

Based on conducting a three year analysis of gross receipts, it has been noted that the organization received 100% of income during tax years ending December 31, 20XX, December 31, 20XX and December 31, 20XX from Investment Income. The gross receipts received by the Club are over the 35% threshold permitted in Public Law 94-568.

The Club has made charitable contributions to organizations exempt under IRC Section 501(c)(3) within their community. The Club has indicated if they are not exempt under IRC § 501(c)(7)—Social Club, they are exempt under IRC § 501(c)(4)—Social Welfare Organization, due to these charitable contributions.

## LAW

Internal Revenue Code § 501(c)(7) exempts from Federal income tax: "Clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and not part of the net earnings of which inures to the benefit of any private shareholder."

Section 1.501(c)(7) of the Income Tax Regulations provides that, in general, the exemption extends to social and recreation clubs supported solely by membership fees, dues and assessments. However, a club that engages in a business, such as making its social and recreational facilities open to the general public, is not organized and operated exclusively for pleasure, recreation and other non-profitable purposes, and is not exempt under section 501(a).

Prior to its amendment in 1976, IRC § 501(c)(7) required that social clubs be operated exclusively for pleasure, recreation and other non-profitable purposes. Public Law 94-568 amended the "exclusive" provision to read "substantially" in order to allow an IRC § 501(c)(7) organization to receive up to 35 percent of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt

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status. The Committee Reports for Public Law 94-568 (Senate Report No. 94-1318 2d Session, 1976-2 C.B. 597) further states:

(a) Within the 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter do not represent more than 15 percent of total receipts.

(b) Thus, a social club may receive investment income up to the full 35 percent of its gross receipts if no income is derived from non-members' use of club facilities.

(c) In addition, the Committee Report states that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facilities, that income is not to be included in the 35 percent formula.

Revenue Ruling 66-149 holds a social club as not exempt as an organization described in Internal Revenue Code § 501(c)(7) where it derives a substantial part of its income from non-member sources.

Revenue Procedure 71-17 sets forth the guidelines for determining the effect of gross receipts derived from the general public's use of a social club's facilities on exemption under Internal Revenue Code § 501(c)(7). Where nonmember income from the usage exceeds the standard as outlined in this Revenue procedure, the conclusion reached is that there is a non-exempt purpose and operating in this manner jeopardizes the organization's exempt status.

Section 501(c)(4) of the Code provides for the exemption from federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the community. An organization embraced within this section is one that is operated primarily for the purpose of bringing about civic betterments and social welfare.

Reg. 1.501(c)(4)-1(a)(2)(ii) states that social and recreational activities are not social welfare activities. However, even if a substantial part of an organization's activities consists of social functions for the benefit, pleasure, and recreation of its members, it may qualify for exemption under IRC 501(c)(4) if it is primarily engaged in social welfare activities.

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Internal Revenue Code § 501(c)(4)(B), applicable to all section 501(c)(4) organizations, requires that no net earnings inure to the benefit of any private shareholder or individual with respect to such organization.

### **TAXPAYER'S POSITION**

Taxpayer's position is that the Club's exempt status should be modified to an organization that is exempt under IRC § 501(c)(4)—Social Welfare Organization.

ORG is a membership organization that conducts and supports activities that better the community as a whole. For the years under examination, the ORG. made the following donations to the community, with the amount of Investment Income represented directly below it:

	20XX	20XX	20XX
Total Grants and similar amounts paid	\$ 0	\$ 0	\$ 0
Total Investment Income	\$ 0	\$ 0	\$ 0

The grants and donations were made to other organizations in the community of City, State to help them support their missions. Those organizations include, but are not limited to:

- Receptient-1 for educational costs of Catholic schools and
- Receptient-2 for cost of retreats, church functions, and facilities.

The Club notes that the grants and donations made year ending December 31, 20XX is over % of their investment income and over 0% in years ending December 31, 20XX and December 31, 20XX.

### **GOVERNMENT'S POSITION**

ORG. has exceeded the 35% threshold permitted in Public Law 94-568 for organizations exempt under IRC § 501(c)(7) on a recurring basis during tax years ending December 31, 20XX, December 31, 20XX and December 31, 20XX.

In addition, although an organization that is exempt under IRC § 501(c)(4)—Social Welfare Organization, is a membership organization that conducts and supports activities that better the community as a whole, the ORG. does not meet all the requirements to be exempt under this code section.

Internal Revenue Code § 501(c)(4) provides for the exemption from federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the

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promotion of social welfare. Making contributions, albeit to organizations within a community, does not mean that the Club is engaged in social welfare activities. The club cannot qualify under this section of the Code as it merely makes grants and/or contributions to other charitable organizations. It is possible that the club could qualify as a private foundation, but it would need to apply for such status. The important point here is that the club simply accrues investment income and provides grants. Periodic meetings to discuss social welfare are held. However, activities using individuals to promote neither social welfare nor other forms of services that would lend itself to the promotion of social welfare exists.

Consequently, revocation of the ORG. exempt status as an organization exempt under IRC § 501(c)(7) is warranted.

### **CONCLUSION**

ORG. no longer qualifies for exemption under Section 501(c)(7) of the Internal Revenue Code, as the Investment Income has exceeded the 35% threshold permitted in Public Law 94-568. Therefore, exempt status under § 501(c)(7) of the Internal Revenue Code should be revoked effective May 25, 20XX. Should this revocation be upheld, Form 1120 must be filed starting with tax periods ending December 31, 20XX.

Note: If you are planning to appeal the proposed revocation, please refer to Publication 892 which is enclosed. Appeal should contain statement of facts declared true under penalties of perjury. Please refer to Publication 892, page 3 for example of statement signed under penalties of perjury.